Date Mailed August 10, 1998

BEFORE THE

PUBLIC SERVICE COMMISSION OF WISCONSIN

Investigation on the Commission's Own Motion Into Utility Business Activities and Into Transactions and Relationships Of Utilities and Their Affiliates During the Transition to Restructured Electric and Gas Industries; Potential Effects of Increased Competition on Markets and Consumers	05-BU-101

NOTICE OF HEARING

Hearings begin October 19, 1998, 10:00 a.m., at the Public Service Commission, 610 North Whitney Way, Madison. The public is welcome to attend.	
Direct Testimony is Due: **September 9, 1998, 4:30 p.m.**	**In addition to providing a copy of prefiled testimony and exhibits to each party on the attached Service List, please provide 15 copies, along with a cover letter to:** **Donna L. Paske, Hearing Examiner** **Public Service Commission** **P.O. Box 7854** **Madison, WI 53707-7854**
Rebuttal Testimony is Due: **September 30, 1998, 4:30 p.m.**	
Surrebuttal Testimony is Due: **October 14, 1998, 4:30 p.m.**	

Hearings <u>specifically for the public</u> will be held as follows:

Serb Hall **5101 West Oklahoma** **Milwaukee, Wisconsin**	**November 2, 1998, 10:00 a.m., 1:30 p.m., and 7:00 p.m.**

With the advent of electric utility restructuring and the potential for deregulation of some services, the Public Service Commission of Wisconsin (Commission) determined that standards of conduct governing the relationships between public utilities and their affiliates should be developed. Most small business-related inquiries and complaints received by the Commission are about how nonutility activities are defined and what nonutility activities are allowed within the utility. To move forward with affiliated interest standards of conduct for the energy utilities, it is crucial that the Commission establish direction on which activities may be allowed within the utility, regardless of how energy industries may be segmented or structured in the future. Consequently, the Commission authorized this docket.

This process of developing standards of conduct between public utilities and their affiliates is segmented into three phases. The first phase, to be addressed in this docket, consists of developing Commission policies on the extent that diversification into nonutility activities within the utility should be regulated, limited, or prohibited by the Commission. The policies established in Phase I will then be used in Phase II when an administrative rulemaking proceeding is opened to promulgate rules on utility and affiliated interest standards of conduct. Phase III will be to conduct an ongoing statutory review to determine if any statute revisions are needed as a result of Commission policies and standards established during Phases I and II. Phase III will run concurrently with Phases I and II and will permit proposed statutory recommendations, if necessary, to coincide with the beginning of the 1999 legislative session. During Phase II, administrative rules on electric energy marketing will be developed and the Commission policies established in docket 05-GI-108, Phase II, on natural gas marketing, will be incorporated into administrative rules.

A prehearing conference was held for this docket on June 30, 1998, in Madison. The hearing in this docket will be the forum for presenting and supporting positions on the extent that diversification into nonutility activities within the utility should be regulated, limited, or prohibited by the Commission. The issue list developed at the prehearing conference for use at the hearings is enumerated in Attachment 1. The issue list is in the form of questions that should be addressed in prefiled testimony for this phase of the docket. Commission staff offers two positions in Attachment 2, entitled the “Allocation Viewpoint” and the “Separation Viewpoint,” and common definitions in Attachment 3 as a starting point from which participants may develop their individual positions. Participants wishing to deviate from definitions in Attachment 3 will be expected to provide their definition of such terms in the context of any prepared testimony or exhibits for the hearing record.

This is a Type III action under s. PSC 4.10(3), Wis. Adm. Code. No unusual circumstances suggesting the likelihood of significant environmental consequences have come to the Commission’s attention. Neither an environmental impact statement under s. 1.11, Stats., nor an environmental assessment is required.

NOTICE IS GIVEN that this matter is considered to be a Class 1 proceeding as defined in s. 227.01(3)(a), Stats.

NOTICE IS FURTHER GIVEN that, if this proceeding is contested, Commission staff shall file a synopsis or summary of the testimony or other evidence presented at the hearing in this case. The parties, pursuant to s. 196.24(3), Stats, as amended by 1997 Wisconsin Act 204, Section 24, may demonstrate that a synopsis or summary is not sufficiently complete or accurate to fairly reflect the relevant and material testimony or other evidence presented at the hearing.

NOTICE IS FURTHER GIVEN that hearings will be held for this docket beginning on Monday, October 19, 1998, at 10:00 a.m., in the Amnicon Falls Hearing Room at the Public Service Commission Building, 610 North Whitney Way, Madison, Wisconsin. Hearings will continue at times and places to be set by the presiding hearing examiner. This building is accessible to people in wheelchairs through the Whitney Way main floor (lobby) entrance. Parking for people with disabilities is available on the south side of the building. Hearings specifically for public comment will be held on November 2, 1998, at 10:00 a.m., 1:30 p.m., and 7:00 p.m. at the Serb Hall, 5101 West Oklahoma, Milwaukee, Wisconsin. This building is also accessible to people in wheelchairs. Any person with a disability who needs accommodations should contact Richard Teslaw at (608) 267-9766.

Questions regarding the hearing scheduled in this notice should be addressed to Donna Paske, Examining Division at (608) 266-7173.

Other questions regarding this matter may be directed to Candice Spanjar, Electric Division at (608) 267-9537.

Dated at Madison, Wisconsin, ____

For the Commission.

____

Susan E. Stratton
Administrator
Electric Division

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DOCKET O5-BU-101
ISSUE LIST/PREFILING QUESTIONS

I. DEGREE OF SEPARATION REQUIRED OR ALLOCATION ALLOWED

A. Describe the scenario you believe should be adopted. To the extent possible, build off of either the separation or allocation example.

B. Provide rationale for your position. Quantify benefits. Examples may be useful. To support your position, you may wish to provide evidence which shows ways in which your position is superior to other positions (e.g., show the detriments of the alternative positions).

C. What criteria/conditions should the Commission use to determine what activities should be allowed within the utility structure? Make comments on the applicability of broad-based criteria and on very specific criteria/conditions.

1. Comment on whether activities meeting the criteria/conditions should be a utility service/activity or only provided on a nonutility basis (i.e., above the line or below the line).

2. Given the gas safety standards, general reliability concerns and the essence of the winter moratorium, what services should a gas utility be able to provide its gas customers as a utility service? As a nonutility service?

3. How are your answers different for electric utilities?

II. EFFECTS, MODIFICATIONS, AND EXEMPTIONS

A. Comment on the impact your proposal would likely have on entities such as the following:

1. Customers (residential, agricultural, commercial, industrial) of utility services and customers of nonutility services
2. The utility, with attention to the impact on:
   a. existing resources and assets
   b. programs grandfathered under the holding company statutes
   c. development of new programs or services
3. Utility shareholders
4. The utility's corporate structure or holding company
5. Nonutility competitors

B. Does your proposal require modifications or exemptions to accommodate special circumstances such as:

1. The utility's size
2. It is a municipally-owned utility
3. Geographic and/or economic differences in the state
4. It is a multi-state utility

III. APPLICABILITY AND EFFECTIVENESS OF REGULATION

A. Comment on the authority of the Commission and the applicability and effectiveness of regulation under your proposal. Direct your comments to regulation by the Commission and by any other regulatory bodies.

B. What consideration should the Commission give to the potential results of a proposal that limits what the utility can do, given the Commission has no authority over most nonutility competitors and little authority over cooperatives that provide utility service?

C. What statutes, rules or accounting changes may be necessary to facilitate your proposal?

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Docket 05-BU-101
ALLOCATION VIEWPOINT

Description

The allocation position allows utilities to diversify within the utility structure on a nonutility basis ("below the line"). Although utility activities ("above the line") would be limited to those necessary for the provision of utility service plus related incidental services, substantial levels of nonutility services would be permitted under this position.

Under the allocation position, utilities would be permitted to engage in nonutility activities that utilize the assets, operations, and expertise associated with the offering of utility service, provided that the associated costs are fully-allocated and not borne by ratepayers.

Two rationales justify this position. First, similar to nonregulated corporations, a utility is a business entity with a desire to prosper on a long-term basis. It has the incentive to change and evolve in order to maintain or increase its earnings and its viability as a corporate entity.

Second, a utility has short-term economic incentives to diversify. By using utility assets in nonutility businesses, the utility generates revenues that more than offset the costs associated with utilizing these assets. This more efficient use of assets reduces the costs the ratepayers pay for those assets.

Notwithstanding these reasons, certain parameters or conditions would need to be established to limit nonutility activity. For example, it is likely that one appropriate limitation would be designed to protect the financial integrity of the utility. The development by a public utility of disparate interests and responsibilities could divert the attention of corporate managers from what would otherwise be their primary concern, the efficient delivery of utility service. Moreover, significant business losses in nonutility ventures would inevitably have an impact upon the financial stability of the public utility. These losses might be passed on to the ratepayers served by the regulated portion of the utility.

Financial integrity protection could be implemented by setting a minimum level of utility equity. Utility equity would be determined by subtracting nonutility investments from common stock equity on the basis that the nonutility investments are 100 percent equity financed. The proper minimum level of utility equity would be set in an individual rate case or other formal proceeding. A minimum level of 45 percent utility equity, for example, would be the default level for utilities not having an individualized level set in a proceeding.

Other appropriate limitations may be implemented to protect the functioning of the market into which the utility provides nonutility services. A utility should not have an unfair market advantage over other entities that may already be providing a similar service or that may wish to enter a market. On the other hand, a utility should not be prohibited from competing in a nonutility market or have unreasonable conditions imposed on it so that other market participants do not feel competitively threatened.

Justification for the Allocation Position

In reality, investor-owned utilities share many characteristics with nonregulated businesses, including the financial necessity to provide a return to stockholders. Historically, nearly every aspect of a utility's business has been subject to regulatory scrutiny, including corporate growth and diversification. Restructuring and deregulation in energy markets stimulate change in individual utilities and also challenge the theoretical underpinnings that support the provision of monopoly service. Utilities will need to evolve to maintain and attract investment as regulated services become competitive.

Utilities across the nation are currently looking at what they do best and are trying to determine how those skills could be applied to more than just the provision of monopoly utility services. Utilities are also looking at ways to "add value" to the services they currently provide. Value-added services are expected to be responsive to customers' wants and needs and to provide customer convenience, while at the same time providing the utility with sales of additional services. The question regulators must wrestle with is how to allow corporate structures the freedom to grow while protecting the interest of the ratepayers and the greater public good. The allocation position suggests it can be done.

Size alone should not be a significant factor in determining what services or activities are allowed or prohibited within a utility. Everyday, large multistate corporations in other industries capture market share from smaller, locally-owned businesses. These smaller entities must find a niche to serve or risk going out of business. Under competitive market models, this is not necessarily a bad thing. In this context, it is important to recognize that utilities are not the only "big" players that have resources available for activities in other attractive markets. The fact that a utility, rather than a nonutility corporation, is involved should not make a difference as long as the utility is not unfairly cross-subsidizing the competitive activity. In contrast, it would be a disservice to the marketplace if regulatory action prevented an otherwise viable competitor, the utility, from participating in a market, especially if that competitor is potentially more cost efficient than other participants.

Similarly, utility name recognition or goodwill should not prevent a utility from competing in nonutility markets. Recently, the Minnesota Supreme Court found that the value of a gas utility's name and reputation is generally not considered a "cost" of rendering utility service and that the costs associated with this name value have not been borne by the ratepayers. In other words, if the cost of generating goodwill was not directly paid for by ratepayers, use of that goodwill in nonutility activities is not an improper subsidization by ratepayers.

The allocation position is also more consistent with the status quo. Regulators have long relied on allocation methods to divide costs between utility and nonutility functions. The Uniform System of Accounts expressly provides for it. If restructuring and deregulation continue, allocation between utilities and affiliates, especially service companies, will continue and in all likelihood take on even greater importance. This may generate the need for more sophisticated accounting and auditing systems. However, proper application of these same accounting systems could be utilized to prevent cross-subsidization between utility and nonutility functions performed within the utility structure.

Identification of a More Extreme View

The allocation position does not fall on the far end of the spectrum of possible structures. A more extreme view would be one in which a utility, on a nonutility basis, could engage in any type of activity, provided associated costs are not borne by the ratepayers. State statutes would still prevent a utility from securing debt for nonutility purposes, but there would be no condition established concerning preservation of a utility's financial integrity. Unless the current holding company statutes remain, the regulated utility function could be dwarfed by the other business within the corporate structure. There would be considerable reliance on the market, with little regulatory control.

Presumably, a utility would not be able to cross-subsidize nonutility functions even at the extreme end of the spectrum. Costing methodologies could be different, however. Incremental costs could be used as opposed to fully allocated costs. Tying arrangements such as package deals or other types of discounts may be acceptable at this end of the spectrum as well.

Docket 05-BU-101
SEPARATION VIEWPOINT

Description

The separation position restricts the types of allowable activities that can be provided by utilities. This requires greater separation of utility and nonutility activities and the resources needed to provide these services or products than under the current regulatory structure. The restrictions inherent to this position are intended to prevent the utility from participating in markets with advantages gained as a result of its regulated status and to prevent unfair ratepayer cross-subsidy of nonutility activities.

Under the separation position, utilities may engage in activities that are considered to be essential utility services. These activities would be allowed above the line. Activities required by law would also be considered essential utility services as well as services that are provided in response to circumstances which reasonably appear to endanger public or individual human life, health, or safety.

This position allows only limited activities to be provided by the utility on a nonutility basis, or below the line. An nonutility activity may be provided only if the activity meets all of the following conditions:

(1) Is related to utility business.
(2) Is incidental to the utility's business.
(3) Is not provided by others in the market to any significant degree.
(4) Its costs can be reasonably allocated.

These restrictions would not allow utilities to provide many of the services and products they have recently ventured into, such as the sale of carbon monoxide detectors, processing of payments for third parties, and certain appliance leasing programs outside of the utility service territory.

Depending on the circumstances, under this position ratepayers could either benefit by eliminating the chance of cross-subsidizing nonutility related activities, or see their share of costs increase if certain economies due to sharing of resources are not realized.

Justification for the Separation Position

The separation position is rooted in the belief that a utility should only be allowed to engage in activities considered to be essential utility services. As the gas and electric industries are restructured and services are unbundled, what is considered an essential utility service may change. For example, demand-side management is now considered an essential utility service because participation by utilities in the energy efficiency market is still needed to ensure the efficient use of gas and electricity. However, in the future, the efficiency market is likely to have sufficiently changed, perhaps making utility participation in the market unnecessary or undesirable.

Separation of utility and nonutility activities avoids the danger that nonutility activities may harm ratepayers or competitive markets through cross-subsidization. It reduces the opportunity for the utility to shift costs of competitive goods and services onto its utility customers.

To avoid the harm of cross-subsidization, there needs to be the ability to first identify and then make a simple and transparent allocation of common costs. In most cases, making this determination requires regulators to make an extensive review of a utility's activities, its books and records. This is increasingly complicated and time consuming as utilities continue to explore new market opportunities. In addition, the allocation process is potentially arbitrary. Allocating overhead and other joint costs between utility and nonutility activities is subject to error and disagreement. Separating activities is the simplest and surest way to avoid these problems. If all costs associated with nonutility activities cannot be identified and properly allocated, the utility ratepayer could be cross-subsidizing competitive ventures.

An additional reason supporting the separation position is that it provides a useful transition to the possible future utility structure. As a result of restructuring, it is anticipated that the regulated part of utility business may be greatly reduced from what it is today. This is fundamentally a means of separating the utility into distinct business units. The separation position is consistent with this view of restructuring as it requires a utility to pursue competitive ventures on a stand alone basis.

The separation position also addresses concerns that other competitors may have about intangible competitive advantages that may have accrued to a utility. Examples include name recognition, easy access to a large customer base and ready availability of technical expertise. Without separation, name recognition may result in unjustified customer confidence and satisfaction with nonutility products and services provided by the utility. This, coupled with access to customer information, provides a clear advantage when a utility enters a competitive market. In addition, a utility may be expected to take advantage of experienced utility employees when conducting nonutility activities. Ready access to skilled personnel is an advantage smaller competitors may not have. The availability of these resources allows a utility to avoid costs associated with developing competent staff for these ventures.

Although the separate position prohibits utilities from engaging in many nonutility activities, it does not preclude nonutility activities conducted by affiliates of a utility, subject to the provisions of the Holding Company statute.[1] Therefore, the restrictions inherent in this position may not be as limiting as they first appear.

The following paragraphs provide more explanation of the types of activities which might be allowed below the line.

Activities that are indirectly related to utility service and incidental in nature

If the utility has personnel or other resources necessary to provide essential utility services that are underutilized, it could lower ratepayer costs by more efficiently utilizing these employees or resources to provide below the line services or products. As long as the services or products meet the criteria set out above, they could be offered by the utility. This is on the basis that ratepayers would not be harmed. As an example, a utility might use underutilized employees to provide line maintenance and repair services to local municipalities. Proper nonutility use of an employee or resource assumes that no utility employee would be used primarily for providing the incidental nonutility services. (Note that here, "incidental" means providing service at an insignificant level, primarily to better utilize resources already obtained for the provision of utility service.)

Products and services not adequately provided by others.

Utilities could not provide nonutility products and services if there is an existing or emerging competitive market for the products and services. A determination of an adequate competitive market would be based on the number, size, and quality of other competitors; characteristics of the buyers; the geographic characteristics of the market; and the maturity of the market. If it is

[1] The state Holding Company Law restricts the level of nonutility diversification, expressed as percentage of utility assets [s. 196.795(5)(p), Stats.]; requires that nonutility ventures meet certain desirable social goals [s. 196.795(7), Stats.]; restricts nonutility affiliates, within the utility's service territory, from selling at retail, leasing, installing or maintaining any appliance that uses as its primary energy source power supplied by the utility [s. 196.795(5)(q), Stats.]; and, requires that a holding company system may not be operated in a way that materially impairs the credit or ability of the utility to acquire capital on reasonable terms, or the ability of the utility to provide safe, reasonable, reliable, and adequate utility service [s. 196.795(5)(g), Stats.].

determined that there is a competitive market for a product or service, the utility could not participate in the market although the product or service could be provided by a nonutility affiliate. For example, a utility would not be able to sell carbon monoxide detectors because these are abundantly available in the marketplace. Also, utilities could not participate in area lighting if the Commission concluded an adequate competitive market existed, or was emerging, for this service.

Identification of a More Extreme View

The separation position does not fall on the far end of the spectrum of possible structures. A more extreme view would prohibit a utility from engaging in any activity below the line and require all nonutility activities to be conducted by affiliates. Under this position, a utility would be permitted to provide only utility service. This extreme application of a separation theory incorporates a significant "bright line" test and would be easy to administer. However, it would preclude a utility from defraying ratepayer-borne costs through more efficient use of utility assets. Another more extreme view would ban affiliates of a utility from competing in the service territory of the utility.

Docket 05-BU-101 Definitions

Above the line. The components of a utility's income statement that appear above the Operating Income line. These include the revenues and expenses that are attributable to the furnishing of utility service and are therefore taken into account in determining just and reasonable rates for utility service. The costs and benefits of these services are attributed to ratepayers rather than shareholders.

Activity related to utility service. Provision of a product or service which utilizes the assets, operations, or expertise associated with the offering of utility service. A related activity may or may not be "incidental."

Affiliated interest. With respect to a public utility, affiliated interest has the meaning given in s. 196.52(1), Stats.

Affiliated interest agreement. An agreement subject to s. 196.52, Stats.

Below the line. The components of a utility's income statement that appear below the Operating Income line. These are revenues and expenses that are not attributable to the furnishing of utility service and are therefore not taken into account in determining just and reasonable rates for utility service. The costs and benefits are attributed to shareholders rather than ratepayers.

Commission. The Public Service Commission of Wisconsin

Cross-subsidy. The allocation of costs of one or more services provided by a company to reduce the costs allocated to other services provided by the company. Alternatively, setting the price of service A higher than the cost of providing that service to allow the price of service B to be set below its cost of service. Cross-subsidy can occur between affiliated entities. They can also occur within and between regulated, partially regulated, and nonregulated services offered by a single entity.

Holding company system. Has the meaning given in s. 196.795(1)(i), Stats.

Incidental activity. The provision of a product or service that will more fully utilize resources already obtained for the purpose of providing utility service. To be incidental, the provision of such products or services cannot require additional staff and must be either:

1) not provided on a regular basis and not pursued or marketed by the utility, or

2) if provided regularly, it is provided as a convenience or service to customers, not as a business niche for the utility. An example of this would be an investor-owned electric utility providing rubber glove testing for a neighboring municipal utility.

Revenues from incidental products or services are currently recorded in utility operating accounts, above the line (e.g., the rent received from a cable company for utilizing space on an electric pole used to distribute electricity).

Nonutility product or service. A product or service which is not a utility product or service.

Shared employee. Any individual employed by a utility or affiliated interest who performs tasks or services for both the regulated utility (above the line) and the nonregulated business (below the line or affiliate).

Tariffed service. A service for which the Commission has an approved tariff on file. Tariffs are, in general, the rates, rules, regulations, and terms and conditions of service of a public utility.

Utility. Means a public utility as defined in s. 196.01(5), Stats., that provides electric or natural gas service and includes any person acting as an agent of the utility for any electric or natural gas service.

Utility employee. An officer, director, employee, or agent of a utility.

Utility product or service. A product or service that the Commission has deemed to be in the public interest because it is important and necessary in the provision of efficient, safe, and reliable electric or natural gas service to the utility's respective customers. Related activities required by law are also considered to be a utility product or service.

ATTACHMENT 4

BEFORE THE

PUBLIC SERVICE COMMISSION OF WISCONSIN

Investigation on the Commission's Own Motion Into Utility Business Activities and Into Transactions and Relationships of Utilities and Their Affiliates During the Transition to Restructured Electric and Gas Industries; Potential Effects of Increased Competition on Markets and Consumers	05-BU-101

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(July 29, 1998)

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